

Message Text

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ACTION EUR-12

INFO OCT-01 ISO-00 AID-05 CEA-01 CIAE-00 COME-00 EB-07

FRB-03 INR-07 NSAE-00 CIEP-01 SP-02 STR-04 TRSE-00

LAB-04 SIL-01 SAM-01 OMB-01 NSC-05 SS-15 H-02 L-02

PA-01 PRS-01 USIA-06 /082 W
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R 011810Z APR 75

FM USMISSION EC BRUSSELS

TO SECSTATE WASHDC 8578

INFO ALL EC CAPITALS 491

AMEMBASSY BERN

AMEMBASSY OSLO

AMEMBASSY STOCKHOLM

AMEMBASSY VIENNA

C O N F I D E N T I A L SECTION 1 OF 2 EC BRUSSELS 2859

E.O. 11652: ADS - "DECLASSIFIED ON JAN 1, 1978"

TAGS: EFIN, EEC

SUBJECT: EC COMMISSION VIEWS ON THE INTERNATIONAL MONETARY
SITUATION

REFS: A. EC BRUSSELS 2406

B) EC BRUSSELS 2526

C. EC BRUSSELS 2649

D. EC BRUSSELS 2527

1. SUMMARY: EC COMMISSION FINANCIAL OFFICIALS BELIEVE
THAT THE US SHOULD FOLLOW PRUDENT ECONOMIC POLICIES TO
INCREASE CONFIDENCE IN THE DOLLAR AND TO AVOID ANOTHER
INTERNATIONAL MONETARY CRISIS IN 1977. END SUMMARY.

2. THE SHORT RUN - FRAGIL MONETARY SITUATION: EC
COMMISSION OFFICIALS DEALING WITH FINANCIAL AFFAIRS
BELIEVE THE CURRENT INTERNATIONAL MONETARY SITUATION
IS IN A PRECARIOUS STATE. THE SUSTAINED AND SHARP
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DEPRECIATION OF THE DOLLAR EXCHANGE RATE RAISES QUES-

TIONS OVER THE DESIRABILITY OF HOLDING DOLLAR ASSETS AND HAS UNDERCUT PUBLIC CONFIDENCE IN THE DOLLAR. THESE OFFICIALS, HOWEVER, SEE NO IMMEDIATE ALTERNATIVE TO THE DOLLAR AS THE WORLD'S RESERVE CURRENCY. THEY FORECAST SOME IMPROVEMENT IN THE DOLLAR RATE OVER THE NEXT YEAR, BUT SEVERAL ARE NOT OPTIMISTIC ABOUT THE DOLLAR'S MEDIUM-TERM PROSPECTS. THEY NOTE THAT THERE IS NOW OVER \$230 BILLION OF OFFICIAL FOREIGN RESERVE ASSETS, AND INTERNATIONAL LIQUIDITY CONTINUES TO EXPAND RAPIDLY.

3. NEED FOR PRECEDENCE: KEY FINANCIAL OFFICIALS HERE ADVISE THAT THE US NEEDS TO FOLLOW PRUDENT ECONOMIC POLICIES IN ORDER TO SHORE UP CONFIDENCE IN THE DOLLAR. THEY DISAGREE WITH IRISH FINANCE MINISTER RYAN'S ASSESSMENT THAT THE US NEEDS TO REFLATE RAPIDLY (SEE REFS A AND B). THEIR ASSESSMENT IS JUST THE OPPOSITE: THE US MUST AVOID A POLICY OF EXCESSIVE EXPANSION WHICH WOULD INCREASE FURTHER THE DISPARITY BETWEEN US AND EC INTEREST RATES AND WOULD REKINDLE PRICE INFLATION. THEY BELIEVE THAT THE INTERNATIONAL MONETARY SITUATION HAS ADEQUATELY WITHSTOOD THE TRAUMA OF THE PAST YEAR AND CONDITIONS SHOULD NOW IMPROVE, AT LEAST IN THE SHORT-RUN. NEVERTHELESS, THEY ARE CONCERNED OVER THE EXPANSIONARY PROGRAM PROPOSED BY THE CONGRESS.

4. POLICY ALTERNATIVES: SHOULD THE UPWARD SWING OF THE DOLLAR EXCHANGE RATE OF THE PAST TWO WEEKS CONTINUE, COMMISSION OFFICIALS BELIEVE THE MAJOR INDUSTRIALIZED COUNTRIES NEED ONLY TO FOLLOW LIMITED EXPANSIVE POLICIES TO STABILIZE THE CURRENT SITUATION. THE US CAN DO LITTLE TO EASE THE EXISTING INTEREST RATE DIFFERENTIALS. THEY RECOGNIZE THAT THE US IS NOW NOT IN THE ECONOMIC POSITION TO RAISE ITS DOMESTIC INTEREST RATES. THEY BELIEVE, HOWEVER, THAT MARKET FORCES WILL LIKELY DRIVE UP US RATES. SHOULD THIS HAPPEN, BY THE END OF THE YEAR THERE COULD BE A LARGE INFLOW OF CAPITAL INTO THE US. ON THE OTHER HAND, THEY RECOGNIZE THAT THIS WOULD AGGRATE THE

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BALANCE OF PAYMENTS SITUATION OF THE EC COUNTRIES FACING CURRENT ACCOUNT DEFICITS.

5. QUEST FOR STABILITY: COMMISSION OFFICIALS DESCRIBE THE EXPERIENCE WITH FLOATING EXCHANGE RATES AS A PAINFUL LESSON. FLOATING RATES ARE NO PANACEA. DESPITE FLOATING RATES, MONETARY CONDITIONS FORCE DEFICIT COUNTRIES TOWARD RESTRICTIVE MEASURES.

DOMESTIC MONETARY POLICY IS STILL DEPENDENT ON INTERNATIONAL FINANCIAL DEVELOPMENTS. ERRATIC EXCHANGE RATE MOVEMENTS HAVE DISRUPTED TRADE AND HAVE HAMPERED THE GROWTH OF EXPORT INDUSTRIES. THE EC CONSEQUENTLY WANTS TO MOVE TOWARD MORE STABILIZATION IN EXCHANGE RATES. STEPS TO SMOOTH OUT DOLLAR RATE FLUCTUATIONS (REF C) AND TO BROADEN THE "MINI-SNAKE" (REF D) ARE INDICATIONS OF THIS DESIRE.

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C O N F I D E N T I A L SECTION 2 OF 2 EC BRUSSELS 2859

6. POSSIBLE NEW INITIATIVES: THESE OFFICIALS DO NOT ADVOCATE A RETURN TO FIXED EXCHANGE RATES. EXCHANGE RATE FLEXIBILITY IS NEEDED, BUT A STEP-BY-STEP PROCESS SHOULD BE UNDERTAKEN TO STRENGTHEN AND STABILIZE THE INTERNATIONAL MONETARY SYSTEM. THE EC IS NOT READY TO ADOPT A EUROPEAN CURRENCY, TO INCLUDE ALL OF THE NINE IN THE "SNAKE", NOR TO ENLARGE ITS SHORT AND MEDIUM CREDIT FACILITIES. INDEED, THE GROWING ECONOMIC DIVERGENCIES AMONG MEMBER STATES MAKE SUCH PROPOSALS IMPRACTICAL.

INSTEAD, THESE OFFICIALS BELIEVE THE EC IS PREPARED TO TAKE NEW INITIATIVES IN THE IMF AND IN OTHER FORA, SUCH AS THE G-10. THE EC BELIEVES THAT IT NOW MAY BE TIME TO ACCELERATE THE PACE OF MONETARY REFORM, STARTING WITH THE JUNE IMF MEETING, AT WHICH TIME A NUMBER OF THE PROPOSED AMENDMENTS TO IMF ARTICLES MIGHT BE ADOPTED.

7. THE MEDIUM TERM--PESSIMISTIC FIRECAST: TWO
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SENIOR COMMISSION FINANCIAL OFFICIALS PROVIDED US WITH THE FOLLOWING MEDIUM-TERM ASSESSMENT. EVEN THOUGH THEY EXPECT THE DOLLAR RATE TO IMPROVE OVER THE NEXT 18 MONTHS OR SO, THESE OFFICIALS ARE SERIOUSLY CONCERNED OVER THE MEDIUM PROSPECTS OF THE DOLLAR. THOUGH THEY RECOGNIZE THAT THE US WILL INEVITABLY TAKE AN EXPANSIONARY DIRECTION, THEY FEAR THAT THIS TREND COULD BE TOO SHARP. THE RESULT COULD BE: CONTINUED US BALANCE OF PAYMENTS DEFICITS AND GROWTH OF THE EURODOLLAR MARKET WHICH WOULD INCREASE OFFICIAL INTERNATIONAL LIQUIDITY TO \$300-400 BILLION BY 1977. AFTER ITS NATIONAL ELECTIONS, THE FRG IS LIKELY TO ADOPT RESTRICTIVE ECONOMIC POLICIES WHICH MIGHT CAUSE A SHARP INCREASE IN CAPITAL INFLOWS. THE FRG WOULD FACE A DILEMMA. EITHER IT PURCHASES LARGE QUANTITIES OF DOLLARS AT A DEPRECIATING VALUE OR IT ALLOWS THE DOLLAR RATE TO PLUMMET TO SUCH A LEVEL THAT MANY EUROPEAN CURRENCIES WOULD BECOME SERIOUSLY OVERVALUED.

8. DM HARD CURRENCY ZONE: FACED WITH THIS DILEMMA, THE FRG AND OTHERS MIGHT BLOCK FOREIGN CAPITAL INFLOWS AND TAKE OTHER ACTIONS TO FREE THEMSELVES FROM A DEPENDENCE ON THE DOLLAR. CURRENCY MARKETS WOULD BE THROWN INTO A CRISIS BECAUSE THE DOLLAR WOULD NO LONGER BE ACCEPTABLE IN SEVERAL MAJOR MARKETS. THE DM MIGHT THEN, AT LEAST IN PART, REPLACE THE DOLLAR AS THE RESERVE CURRENCY. BY 1977 GERMANY MIGHT HAVE PROGRESSED TO THE POINT WHERE THE DM WOULD BE STRONG ENOUGH TO BECOME THE MAJOR RESERVE CURRENCY. THERE ARE INDICATIONS OF SUCH GROWTH. THE DM CURRENCY BLOC--THE "MINI-SNAKE"--IS GROWING IN SIZE. THE EURO-DM MARKET IS EXPANDING. SEVERAL CENTRAL BANKS --TURKEY, ALGERIA AND VENEZUELA--ARE REPORTEDLY SWITCHING RESERVES FROM DOLLARS TO DMS. THE GERMAN ECONOMY IS ONE OF THE MOST STABLE IN THE OECD. WHILE ITS GNP IS NOW ONLY A LITTLE OVER ONE-THIRD OF THE US'S, GERMANY'S CONTINUED ECONOMIC GROWTH AND STABILITY WILL MAKE THE DM AN ATTRACTIVE ASSET

COMPARED TO THE DOLLAR BY 1977.

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9. POSSIBLE ALTERNATIVES: TO AVOID A DOLLAR CRISIS, COMMISSION OFFICIALS HOPE THE US CAN CONTINUE TO PURSUE A CAUTIOUS ECONOMIC POLICY AS EXEMPLIFIED BY THE PRESIDENT'S ECONOMIC PROGRAM. US-EC COOPERATION SHOULD BE STRENGTHENED BY DEVELOPING A COMMON APPROACH TO ECONOMIC POLICIES AND A JOINT RESPONSE TO FUTURE CRISES. THE GROWTH OF INTERNATIONAL LIQUIDITY SHOULD BE CONTROLLED AND STEPS SHOULD BE TAKEN TO REDUCE OFFICIAL FOREIGN DOLLAR HOLDINGS. AN IMF SETTLEMENT MECHANISM FOR OFFICIAL DOLLAR RESERVE ASSETS SHOULD BE CONSIDERED.

10. COMMENT: THE ABOVE VIEWS SUMMARIZED A SERIES OF CONVERSATIONS WITH COMMISSION OFFICIALS IN THE FINANCIAL AREA. THEY, OF COURSE, REFLECT THEIR PREOCCUPATION WITH MONETARY AFFAIRS. SEVERAL TOP COMMISSION OFFICIALS MAY DISAGREE WITH THIS ASSESSMENT. PRESIDENT ORTOLI, FOR EXAMPLE, ADVOCATES THE EC ESTABLISHING A EUROPEAN CURRENCY SO AS TO REDUCE THE EC'S DEPENDENCE ON THE "DOLLAR'S MONETARY POLE". MOST EXPERTS BELIEVE SUCH A PROPOSAL IS NOT FEASIBLE. PERM DEL FINANCIAL OFFICIALS FROM DEFICIT COUNTRIES WOULD ALSO DISAGREE. THEY FEAR THAT THE PROJECTED DECLINE IN THE US ECONOMY WILL AGGRAVATE EUROPE'S ECONOMIC SITUATION.

11. IT IS TOO EARLY TO ASSESS WHETHER IN THE COMING MONTHS THE WEIGHT OF EC POLITICAL OPINION WILL SWING TOWARD RAPID ECONOMIC EXPANSION. SEVERAL MEMBER STATES, ESPECIALLY THE FRG AND FRANCE, HAVE RESISTED SUCH A TREND. A NUMBER OF COMMISSION OFFICIALS IN THE FINANCIAL AREA DO NOT SUPPORT MR. RYAN'S REQUEST FOR RAPID US ECONOMIC EXPANSION. THEY BELIEVE THAT THE US SHOULD FOCUS ON SHORING UP CONFIDENCE IN THE DOLLAR. THEY ARE LIKELY, HOWEVER, ONLY TO BE marginally influential in the formulation of the member states' economic policies. END COMMENT.
GREENWALD

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